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An Independent Central Bank Is Vital To Financial Reform in China

A workshop on financial reform in China was held September 6–13 in Beijing to assist the authorities in drafting comprehensive banking legislation. The workshop, organized jointly by the IMF and the People's Bank of China (PBC), brought together Chinese officials from various agencies involved with ongoing financial reform, as well as a staff team from the IMF's Monetary and Exchange Affairs and Legal Departments, and guest officials from several major industrial countries. Following is a summary of the key issues raised during the workshop, and the IMF staff's understanding of the policy choices facing Chinese authorities.

Yu Peiqiao, PBC Legal Department Director (left); J.B. Zulu, Director of the IMF's Monetary and Exchange Affairs Department; and PBC Vice Governor Zhu Xiaohua.

As part of the transition toward a socialist market economy, the Chinese authorities have embarked on a program of financial reform, aimed at developing a competitive financial system providing a wide range of services to the economy.

A basic prerequisite for achieving this goal, especially for former command economies, is the establishment of a proper legal framework. In a market economy, the state must establish and preserve the framework for conducting transactions while not seeking to control the decisionmaking of market participants. It must also adopt laws suited to the relationships of a market economy and set limits on market freedom. Such a framework for monetary and financial operations consists of three concentric circles:

• An outer circle consisting of various areas of law underpinning a well-functioning market economy. These include essential laws relating to contracts, property, business, civil procedures, and *(Please turn to page 343)*

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SELECTED TOPICS

Asian Model Attests to Value of Openness And Minimal Policy-Induced Distortions

East Asia's strong, consistent growth has piqued interest around the world. Much has been made of an emerging "Asian model"—one that might feature a different, or perhaps larger, role for government in fostering growth. But what does an analysis of East Asia's experience actually reveal about the key elements of this Asian model? Are its lessons applicable for other economies?

Jonathan Ostry, an Economist in the IMF's Research Department, recently reviewed the literature on the Asian experience in the context of New Zealand's efforts to restructure its economy to stimulate growth. His survey found considerable variation in the role played by government in these economies, with relatively little evidence of a greater scope for selective intervention correlated with superior growth performance. Where governments did intervene, the econometric evidence suggests the impact was negative.

Econometric and other analyses for a large number of countries confirm that strong economic growth is linked with minimal policy-induced distortions. Economies draw clear benefits from openness and greater exposure to competition. What this suggests for New Zealand, Ostry concludes, is that its policies—which liberalize key sectors, reduce trade protection, and trim the public sector, are moving the country in the right direction and do not call for government interventions. His overview, entitled *Selective Government Interventions and Economic Growth: A Survey of the Asian Experience and Its Applicability to New Zealand*, will be issued shortly by the IMF in its series of Papers on Policy Analysis and Assessment.

Government and Growth in the Asian Model

The common perception of the Asian success story is that selective government intervention has played a significant role in boosting growth. A survey of that experience, however, suggests that high domestic savings and investment rates, an emphasis on educating and continually training its labor force, flexible labor markets, and access to imported technology and production methods are shared factors in the success of Asian economies. These countries did not, however, share a common approach to the role of government and the scope of intervention in the economy.

Hong Kong, for example, clearly followed a laissez-faire approach, while others—among them Japan, Korea, and Singapore—were more interventionist. Examining individual country growth rates, Ostry finds that superior performance does not correlate with the degree of intervention. A study by the Australian Industries Commission found little link between government intervention on behalf of specific industries and the overall growth rate of Asia's economies. If anything, the study suggests, where success was observed, interventions broadly conformed to the market and were short-lived.

It is often alleged that Japan used public sector resources to favor certain industries, yet the available evidence does not coincide with this perception. Japan's effective tax rates on labor and capital varied less across industries than did those of the United States or the United Kingdom. Likewise, the scope of its involvement in supporting knowledge-intensive industries was small relative to the United States and Germany, and its support for private research and development was below the average for members of the Organization for Economic Cooperation and Development (OECD).

Korea's approach, while clearly not laissez-faire, established a "rough neutrality" among incentives provided to different sectors. In the 1960s, for example, export incentives counterbalanced import controls, and substantial distortions of relative prices were avoided. Korea's experience with more widespread intervention in the 1970s, however, reflects the difficulty governments have in "picking winners."

The experience of Taiwan Province of China appears to strike a middle ground between that of Hong Kong and Korea. Although it employed export incentives, the net effect, over various sectors, was neutral. Singapore, by contrast, actively pursued industrial targeting to achieve a rapid transformation of the economy. The policy of rapid accumulation of physical capital through forced national savings permitted Singapore to increase its investment ratio and surpass Hong Kong's lead in manufacturing. But the review adds several caveats about Singapore's capacity to sustain that growth, noting that its growth in total factor productivity has been small, and its ability to further increase its investment ratio in the future may be limited.

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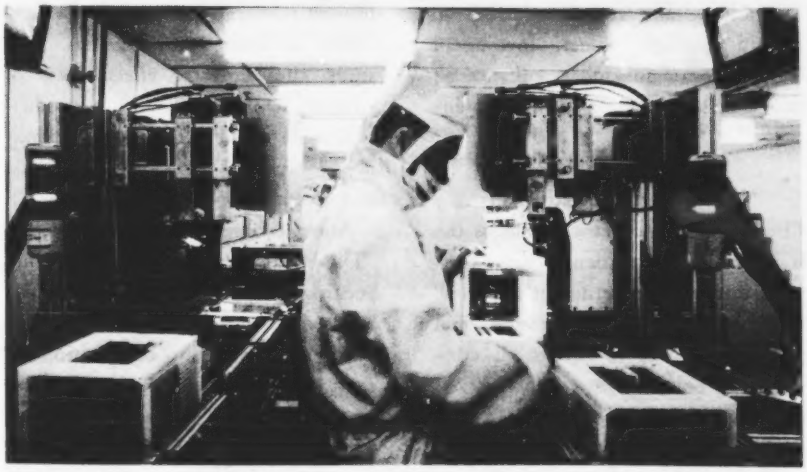
The Econometric Evidence

Ostry also examines econometric results from several major studies that control for investments in physical and human capital, which are known to be correlated with growth. Here, too, he finds evidence pointing to a negative correlation between selective government interventions and growth.

Ostry cites a 1992 study by Vinod Thomas and Yan Wang that investigates the relationship between government policies and growth in China, Hong Kong, Indonesia, Japan, Korea, Malaysia, the Philippines, Singapore, Taiwan Province of China, and Thailand. Thomas and Wang attribute a significant degree of the outstanding economic performance of these countries to "superior policy framework." The study finds that government-induced price distortions in these countries are lower than the average for developing countries. It also finds the effect of a lower level of distortions to be highly significant for economic growth, accounting for two-fifths of the variation in income growth per capita and one-fifth of the variation of total factor productivity growth.

Thomas and Wang also examine the economic performance of these countries through time. They observe that although growth was impressive in the 1960s and 1970s—when interventions were more common—it was much more remarkable in the 1980s after market reforms were instituted. Other multicountry studies cited by Ostry confirm that greater openness stimulates productivity growth, possibly because the importation of capital goods serves as a conduit for technology transfer, and, therefore, the productivity of physical investments increases with greater openness.

Analyses by Jong-Wha Lee and Sebastian Edwards corroborate these findings. Lee reports that trade distortions reduce growth directly, and that indirectly they exert a negative impact on investments in physical capital. Both Lee and Edwards observe that fewer distortions in trade and industrial policies are linked to stronger growth.



A clean room environment at a semiconductor manufacturing facility in Singapore, a country that has pursued industrial targeting to rapidly transform its economy.

Ostry concludes that the consistent message from this research is that fewer government-induced relative price distortions correlate with higher growth, and that more liberal trade and industrial policies, rather than greater government intervention, have been a key factor in the Asian success story.

An examination of several country-specific experiences confirms these results. Lee, in an analysis of a large cross-section of Korean industries, finds that "growth and technical progress would have been higher had the Government reduced the amount of selective interventions." Lee's work points to the great difficulty governments have in "picking winners." Not only is there a significant chance that governments will invest resources in the "wrong" (less productive) industries, but decreased domestic and external competition in these sheltered sectors is likely to leave firms underexposed to competition and less efficient as a result. There is also evidence that Korean firms improved quality and productivity only *after* the Government liberalized imports of competing products.

Public Investment and Growth

Public sector investments in infrastructure and research and development can, in theory, increase the productivity of private capital and spur growth. But they can also appropriate scarce resources and crowd out private investment, inducing a negative impact upon growth. Ostry examines the relative merits of public investment and concludes that the pitfalls of public sector investment are several and potentially significant.

In general, the evidence indicates that public investment has a much smaller effect on per capita growth than private investment. In Asia, public investment had a statistically insignificant impact on growth, according to a study cited by Ostry. Private investment in Asia and Latin America has been markedly more productive than public investment, and the crowding out of private investment by public investment appears to be quantitatively significant. Policies that promote private investment, increase competition and exposure to foreign

technology, and reduce controls on inward foreign direct investment should, Ostry concludes, enhance an economy's long-term growth potential.

"Real World" Distortions

Ostry cites econometric results as the most convincing evidence of the negative impact of government interventions, but he notes that several "real world" examples of distortions convincingly bolster these findings, even though they do not lend themselves to rigorous quantitative analysis. His study examines the impact of two such distortions: labor market distortions and rent-seeking behavior.

Ostry points to evidence gathered in a 1992 study of the impact of labor unions in the United Kingdom in the years after World War II and before the Thatcher period. The 1992 study, by Nicholas Crafts, finds that the power wielded by labor unions was a significant element in the country's relatively low level of productivity growth during that period. In the 1980s, diminished labor union power was associated with a significant narrowing of the gap between the United Kingdom and Germany in real output per hour in manufacturing.

An analysis by the Australian Industries Commission correlates strong growth in Asian economies with flexibility in their labor markets. The study cites "greater effectiveness of workers while on the job, less industrial unrest, and an increased willingness to retrain, undertake new tasks, and accept labor-saving technology."

Anne Krueger's well-known paper, "The Political Economy of the Rent-Seeking Society," suggests that policy-induced distortions may impel productive resources into competition for economic rents, particularly if policies are implemented in a discretionary fashion. Estimates of the cost of such rent-seeking activity vary from country to country but can reach very high levels (40 percent of GNP in India, according to one study).

A liberal and open trade regime can provide governments with a nondiscretionary policy framework that could shield officials from pressures exerted by interest groups. By extension, one reason for Asia's success may have been the discipline and set of constraints its outward-oriented trade policies have imposed on its governments. That discipline may have prevented the adoption of measures severely antithetical to growth in many of the dynamic Asian countries. Moreover, the choice of political systems may well have helped to insulate policymaking from competing political pressures.

Lessons for New Zealand

Robust findings from a variety of econometric and other studies reflect the strong link between high growth and superior policy frameworks and low levels of distortions. Open economies additionally tend to discourage rent-seeking behavior, which, in turn, can help strengthen the quality of policymaking.

These findings reinforce, Ostry notes, the importance of New Zealand's decision in the mid-1980s to reorient its macroeconomic policies and pursue structural reforms. But while New Zealand has persisted in its reform efforts, it has yet to see the large and sustained payoff—in terms of high growth rates—that much of East and Southeast Asia has enjoyed. Ostry suggests that there are apt lessons to be drawn from Asia's experience, but New Zealand's particular circumstances may determine the time frame for results.

When New Zealand embarked on its reforms, he observes, it was one of the most heavily regulated of the OECD countries. Its economy had for years imposed high tariffs, import licenses, and quotas. Selectively interventionist government policies had, in addition, sponsored a series of commercial activities and insulated a high proportion of the New Zealand economy from competition.

Ostry notes that, in the past, New Zealand's relatively poor growth performance has been associated with a failure to increase the efficiency, rather than the quantity, of its investment. High levels of protection, factor and product market rigidities, highly distortionary tax systems, and high and variable inflation rates have all conspired to suppress growth and create an investment climate driven by the wrong signals.

Compounding the country's problems have been labor policies that have, among other things, compressed wages across skill levels and discouraged investments in human capital. External factors, such as growing restrictions on the entry of agricultural goods into world markets and increasing agricultural supports in OECD and many developing countries, have also added to the obstacles New Zealand faces, even as it tries to adopt more liberal and outward-oriented policies unilaterally.

Given the magnitude of the initial

SDR Rates

Week Beginning	Interest and Charges (percent)
Nov. 1	4.13
Nov. 8	4.11

The rate of SDR interest and charges is calculated weekly, by reference to a combined market interest rate, which is the weighted average of interest rates on specified short-term domestic obligations in the money markets of the five countries whose currencies constitute the SDR valuation basket (U.S. dollar, deutsche mark, Japanese yen, French franc, and pound sterling). The interest rates used are those that prevail each Friday. For the latest weekly rates call (202) 623-7171.

Data: IMF Treasurer's Department

distortions, long lags between the implementation of reforms and the intended results are to be expected, Ostry finds. Credibility is usually hard won, and the costs implicit in resource shifts are not to be underestimated.

These costs may have been increased by delays in implementing labor market reforms designed to reward skills and encourage investment in human capital. Time will be needed to redress the skill deficiencies of New Zealand's labor force, but, to facilitate this adjustment process, the Government has moved to improve the responsiveness, effectiveness, and relevance of the country's education system and worker training programs.

Cambodia and Viet Nam Normalize Relations with IMF

Cambodia and Viet Nam have cleared their arrears to the IMF and obtained immediate IMF financing in support of comprehensive macroeconomic and structural reforms. In light of these developments, the process of reintegrating both countries into the world economic and financial system is well under way.

On October 4, the IMF's Executive Board approved a first loan for Cambodia for SDR 6.25 million (about $9 million) under the systemic transformation facility (STF), in support of the Government's 1993–94 transitional reform program. On October 6, the IMF approved financing of SDR 157 million (about $223 million) for Viet Nam; SDR 12.08 million (about $17 million) will be disbursed under the STF, while an additional SDR 145 million (about $206 million) is available over the next 12 months under a stand-by arrangement to support the Government's 1993–94 reform program. (See press releases, *IMF Survey*, October 25, 1993, page 331.)

Welcoming the Cambodian loan, IMF Managing Director Michel Camdessus, during a three-day visit to Phnom Penh in mid-October, attributed the normalization of relations to efforts of a support group headed by France and Japan. He acknowledged the Cambodian authorities' determination to establish a market economy and put in place a suitable administrative and legal framework. Cambodia had achieved real progress toward restoring macroeconomic stability and strengthening institutions of economic management, Camdessus said. Cambodia was also the first country outside Central Europe and the former Soviet Union to receive an STF loan from the IMF.

A street scene in Hanoi. Viet Nam is implementing decisive market-oriented reforms, which have already begun to bear fruit.

Visiting Hanoi to mark the normalization of relations with Viet Nam, Camdessus said that the clearance of arrears was greatly facilitated by grants of members of the support group headed by France and Japan, and by bridge financing. He noted the determination with which the authorities had been implementing decisive reforms needed to move toward a market economy. The measures have already begun to bear fruit, said Camdessus at a press briefing; since 1989, real GDP growth has averaged about 7 percent, and inflation has fallen to below 10 percent. Viet Nam's economic program for 1993–94 aims to build on this base.

While in Cambodia and Viet Nam, Camdessus met with government officials and with representatives of nongovernmental organizations (NGO) and of the business and diplomatic communities. In Cambodia, Camdessus welcomed the significant role played by NGOs in channeling international support for the Cambodian people, particularly during the period in which Cambodia had not fully restored its relations with the international community.

Pamphlet Answers Questions About IMF-Supported African Adjustment Programs

Although most African countries have a long way to go before achieving the sustainable economic growth that is essential to raise the living standards of their populations, some of them have already made significant progress, according to a recent pamphlet entitled *IMF Support for African Adjustment Programs: Questions and Answers*, prepared by F.L. Osunsade, Advisor in the IMF's External Relations Department. The pamphlet answers a number of commonly raised questions about IMF-supported adjustment programs.

According to the pamphlet, the 15 African countries pursuing adjustment programs supported by the IMF have improved their growth and inflation performance. The performance of these countries is encouraging, but it is clear that Africa needs to achieve an overall stronger economic growth if living standards and per capita real income are to improve substantially.

In addition to combating high inflation and disorderly adjustment, which typically hit the poor the hardest, IMF-supported adjustment programs usually include a wide range of measures to alleviate poverty.

To provide even greater protection for the poor in the adjustment process, many African countries will need to consider a bold reordering of public expenditure priorities—for example, by reducing excessive military spending and unnecessary subsidies.

Participation in Reform

The liberalization strategies characteristic of IMF-supported adjustment programs enable people to seek the best possible return on economic assets; their success in using their resources efficiently strengthen their ability to demand and exercise opportunities to participate in good governance.

The IMF has sometimes been criticized because important population groups that may be significantly affected by policy measures under adjustment programs do not normally participate in the policy dialogue between the member country and the IMF. The IMF's working assumption is that because the social and economic goals of an adjustment program reflect the realities and aspirations of the adjusting country, population groups with interests in particular issues should make their views known to their governments through domestic channels. In fact, the IMF encourages member governments to consult with their social partners when major policy reforms are involved.

The evidence from nearly five decades of the IMF's work with member countries in all regions of the world shows conclusively that market-based policies yield better results than those based on government controls. Clearly, people are better off when they are free to pursue their legitimate economic interests to the best of their abilities.

Exchange Systems and Practices

On occasion, the IMF advises adjusting African countries to devalue their currencies. Devaluations are advisable when a currency is seriously overvalued. By officially raising the domestic-currency price of foreign currencies, devaluation increases the prices of internationally traded goods and services relative to those of goods and services traded only in the domestic market, thereby helping to boost profit margins earned from export activity.

A basic requirement for exchange rate regimes is that they should be market-based. Countries may choose to use the exchange rate as an anchor or reference point or they may follow a flexible exchange rate policy. In either case, the accompanying macroeconomic policies must be strong and credible.

Lightening the Debt Burden

The concessional terms and longer maturities of financing provided under IMF-supported adjustment programs are well suited to the needs of low-income African countries. With the reassurance provided by these programs, creditors have begun to develop instruments and mechanisms compatible with the debt problems of these countries.

The recent criticism, that African countries have been recording net financial outflows to the IMF, is misplaced, the pamphlet suggests. In fact, IMF credit has had a catalytic effect; countries that have committed themselves to IMF-supported economic reform programs have usually been able to attract from other sources several times the amount of IMF financial assistance they have received.

The policy dialogue and related reports that are part of the IMF's regular contacts with African countries help, over time, to upgrade the quality of their economic and financial policies, which are the ultimate determinants of their economic progress.

Copies of *IMF Support for African Adjustment Programs: Questions and Answers* are available free of charge from Publication Services, International Monetary Fund, Washington, D.C. 20431, U.S.A. (Telephone: (202) 623-7430; fax: (202) 623-7201.)

Financial Reform in China

(continued from front page) taxation; supporting laws include those of payments, securities, bankruptcy, competition, consumer protection, insurance, labor, and welfare.

• The next circle comprises the law on financial institutions, defining, among other things, financial institutions and activities, licensing requirements and procedures, and supervisory procedures and tools for the monetary authorities.

• The inner circle is the central bank law, which defines objectives, competence, and decision-making procedures.

Reforms in China to date suggest a growing awareness of these essential characteristics of a legal framework. Although a comprehensive commercial code has yet to emerge, a wide range of specialized areas of legislation extends beyond the elements contained in traditional commercial codes. Nonetheless, difficulties persist. These include the licensing and financial position of state-owned banks, their policy-based lending (which administratively directs credit to the economic sectors), and banking supervisory deficiencies. The substantial expertise of China's financial officials needs to be harnessed to address these problems.

The transition to a market-based financial sector from a socialist command economy with market economic elements requires the creation of a strong and independent central bank and sound commercial banking system, under the general supervision of the central bank. This in turn requires comprehensive banking laws that elevate the legal status of the PBC and put in place a legal regime for regulating commercial banks.

Central Banking Law

A well-functioning market economy requires a stable national currency, and central banks have traditionally been the sole issuers of currency. Since the end of the gold standard, they have played a more active role in monetary policy, with the end of the gold standard marking the birth of discretionary monetary policy. This discretionary role was often influenced by government pressure on central banks to risk some inflation by loosening control over money growth. In the early postwar era, the view that some inflation was acceptable to stimulate growth gained credence. Since then, however, analysis and experience have shown that inflation-driven economic growth is unsustainable and costly.

In light of this evidence, thinking has converged on two principles: a central bank should maintain price stability and should be independent of political influence.

Central bank independence requires:

• full operational autonomy, as well as accountability and transparency in conducting central bank operations. There is a growing global trend to adopt legal provisions to protect autonomy, omitting any provision that allows the government to borrow from the central bank. To ensure accountability and transparency, the central bank needs to explain its policy actions and convey economic information to the government, legislature, and public. It must also collect reliable financial statistics by which the goals of monetary policy and central bank actions can be assessed.

• an effective policymaking body. The size and composition of a central bank's policymaking entity are vital. Too large a body may hamper the decision-making process. As to composition, regional representation—especially for a country the size of China—is important. Members of the policymaking board should not be answerable to the government, and government representatives should have only an advisory function and no voting rights.

• coordination with economic policy. Proper coordination between the central bank and the government is critical. Markets and economic agents, for example, should not receive conflicting signals about the direction of monetary policy.

• responsibility for functions that support their primary goal of price stability. These include preserving the stability and soundness of the financial system and managing official foreign exchange reserves and exchange rate policy. To guarantee the stability of the financial system, a central bank must assume a substantive supervisory role and ensure that the payments system functions smoothly.

To manage foreign exchange reserves and exchange rate policy, the central bank must undertake daily operations in the exchange market because these operations and interventions may have a direct impact on the money supply and thus on monetary policy. In China, responsibilities in this area are dispersed, and the PBC law would do well to address this issue.

Strategy for the Transition Period

Although the accumulated experience of financial sector development and central banking practices of market economies hold important lessons for China's financial reform, these must be adapted to China's political, cultural, and economic conditions. At the same time, China must move quickly because the development of its financial system currently lags behind development of its real sector. This disparity risks hampering the orderly

development of the real sector, particularly the special economic zones, the new industrial enterprises, and the agricultural sector.

Although the transition could take a decade or two, the necessary capabilities will need to be acquired rapidly. For example, bank supervision becomes more urgent if the freedom of the marketplace is not to lapse into chaos and disorder. Because a well-functioning financial and payments system is a prerequisite for the conduct of monetary policy and acts as the transmission mechanism for that policy, orderly development of the financial system, together with the maintenance of price stability, should remain the PBC's paramount objective.

The main, immediate financial reform task should be to keep the balance between measures that stimulate competition and the implementation of bank supervision under the law. This will ensure that increasing competition does not lead to excessive risk taking.

As markets develop, the PBC will need to review and adjust the mix of monetary policy instruments away from direct means in favor of indirect means. The first step is the adoption of a general legal framework. With the adoption of a banking and a PBC law, bank supervisory authorities can begin preparing the accompanying regulations (as on liquidity and solvency).

If competition among financial institutions is to be achieved, the playing field must be level. Currently, China's four state-owned banks are not able to compete with new banks, and bank supervision cannot be exercised properly. Thus, policy-based lending needs to be carved out of their balance sheet, and any new lending through them must be phased out—an action that the Chinese Government has taken. Also, nonperforming loans could be taken off the balance sheets of these banks, which could then be recapitalized.

The relative composition of the banking sector should also be considered. If certain big banks dominate, some of the largest can be split, possibly along geographical lines. Subsequently, the state-owned specialized banks should be (re)licensed under the new law and converted into commercial banks, which could then be supervised under the new law.

In the interim, two additional actions can help accelerate financial market development:

- the nationwide integration of the interbank market; and
- the establishment of a nationwide market in tradable short-term government paper (such as three- and six-month treasury bills).

The establishment of nationally integrated markets will help promote uniform price setting. This is a crucial step for nurturing competition and paving the way for indirect monetary policy instruments, because these markets will be the operating field for the PBC's monetary policy intervention.

Because these markets are not yet well developed, a move toward the sole use of indirect monetary policy instruments would be premature. In the interim, the PBC can use more market-oriented credit ceilings, for example, ceilings based on a bank's deposit base. This measure would further stimulate competition as it becomes necessary for banks to attract new deposits. A move toward such an instrument and the establishment of a money market would give banks more freedom to determine the composition of their portfolios. This in turn would stimulate more competition and risk taking by the banks on their own accounts. In addition, the PBC should allow bank interest rates to be set freely within margins determined under the new law.

As the domestic banking system becomes competitive, the PBC will need to adopt a coherent policy for admitting new banks, including foreign banks. When designing a policy toward foreign banks, the PBC will have to exercise caution, because the more competitive foreign banks may hamper the growth of domestic banks. In many countries, however, foreign banks have made substantial contributions to domestic financial development, introducing new financial services, management techniques, and other innovations. On balance, a cautious policy of openness that guarantees a level playing field is desirable.

Before admitting foreign banks, China will need to adopt international accounting standards. It will also require stronger bank supervision, coordination with supervisory authorities abroad, and a more elaborate statistical framework.

These, or similar, strategies should put the Chinese financial sector on the path of accelerated development. As financial markets strengthen, the PBC can further relax its administrative controls over credit and interest rates and move toward the use of indirect monetary instruments. These will allow the central bank to move, over time, from a policy of *setting* interest rates to one of *guiding* them through interventions in the emerging money markets.

Note: The IMF staff team was headed by J. B. Zulu, Director of the Monetary and Exchange Affairs Department; it included Tobias Asser, William Holder, Hoe Ee Khor, Hassanali Mehran, Marc Quintyn, Erna Radifera, and Douglas Scott. Guests included former Bundesbank Board member Leonhard Gleske; Bank of Japan Executive Director Akira Nambara; Banque de France Secretary General Didier Bruneel; Netherlands Bank Deputy Executive Director J.A.H. de Beaufort Wijnholds; Hong Kong Monetary Authority Chief Executive Joseph Yam; and IMF Legal Department consultant William Blair.

FUND ACTIVITIES

How the Gold Market Works

Gold lost its pivotal position in the international monetary system in August 1971, when the United States formally suspended the dollar's convertibility into gold. But even though it has lost its significance as a monetary anchor, gold has not lost its luster. According to Gary O'Callaghan, author of IMF Occasional Paper No. 105, *The Structure and Operation of the World Gold Market*, since 1971 "a global market for gold as an asset in its own right has developed, remaining open around the clock and using a full range of derivative instruments." Moreover, although the international monetary system is no longer attached to a golden anchor, almost one-third of the world's monetary reserves were still being held in the form of gold in 1991.

A Permanent Store of Wealth

The nature of gold has given rise to certain features peculiar to the gold market. Gold is a durable good that is never consumed—"most gold that has ever been brought above ground," according to O'Callaghan, "has remained there," and most of it can be accounted for. Gold is thus highly attractive as a store of wealth, and large stocks, held for investment purposes, can influence prices substantially more than simple additions to the annual supply from new production. Therefore, any consideration of the structure of the gold market has to look beyond the current supply of new gold.

The gold market could not function without the assurance of confidentiality—to both sellers and buyers. This guarantee of confidentiality has produced gaps in the existing knowledge of the structure and operation of the market, making it difficult to calculate annual supply and demand.

Estimating Supply and Demand

Theoretically, the annual supply of bullion should equal turnover and demand. In practice, it is impossible to estimate turnover and equally impossible to estimate all sources of annual supply to the markets. Therefore, according to O'Callaghan, "analysts have confined themselves to estimating sources of supply of new gold and have augmented this figure with estimates of major changes in the composition of existing gold stocks." Market analysts have estimated an average net bullion supply to the private sector of 2,530 tons a year during 1985–91. South Africa continued to be the dominant producer, accounting for about one-third of the total, followed by the former U.S.S.R., which supplied 15 percent, and the United States, which supplied 10.3 percent.

Net market demand is also difficult to estimate because of a dearth of information on hoarding. "Estimates must rely on cross-border movements," says O'Callaghan, "but even these are generally not available for Europe and North America, and market stocks in London and Zurich are not revealed."

An estimated 2,350 tons (roughly 93 percent) was absorbed annually over 1985–91 for fabrication of jewelry and ornaments, implying net private bar hoarding of about 180 tons (7 percent).

Tracking Down Existing Stocks

Existing gold stocks have a significant influence on annual market supply and on prices. According to O'Callaghan, "at the end of 1991, estimated cumulative gold production was over 100,000 tons, and the gold stock . . . was almost 60 times the annual supply of new gold from mines."

Central banks. Central banks and official monetary institutions hold about one-third of these stocks, which, valued at a market price of $350 an ounce, would be worth $330 billion. Therefore, despite their passive role in the gold market, central banks maintain considerable influence.

Former Soviet Union. The breakup of the former Soviet Union has given rise to considerable speculation about the size of its gold reserves and past levels of production and exports. Although it is estimated to be the world's second largest producer of gold, the former U.S.S.R., states O'Callaghan, "has long maintained absolute secrecy regarding its annual gold production, stocks, and sales to the West." The industry consensus before 1991 was that Soviet reserves totaled about 2,000 tons at the end of 1989, but according to information recently made available to the IMF, the figure could be as low as 290 tons (see table).

Stocks in private hands. Since 1968, Gold Fields Mineral Services Ltd. (GFMS) has been estimating bar hoarding, but because the figures for North America and Europe are derived from the yearly residual demand, they are probably not too accurate. Based on these rough estimates, about 25 percent of accumulated gold is thought to be in private stocks, and, according to O'Callaghan, "at least theoretically,

available to enter the market in response to price changes."

Following the Gold Trail

It is difficult to track the flows of gold that move through the markets each year. To preserve the anonymity of individual customers and the confidentiality of their transactions, organizers of the physical gold markets do not reveal information on turnover or volume.

O'Callaghan adopts a "market-centered" approach to estimate yearly flows through primary and secondary gold markets. This approach, he says, "forces one to think in terms of where the flows of bullion must have been derived and sent."

By combining the available information on gold flows (largely from GFMS), O'Callaghan estimates that the combined market supply of gold was 3,225 tons in 1992, with Zurich accounting for almost 30 percent of the total (912 tons), followed by London (511 tons), New York (443 tons), Hong Kong (396 tons), Singapore (215 tons), and the rest divided up among a number of other regional markets.

How the Market Works

The gold market operates from three major locations, each one serving a particular function: the London market determines spot prices of gold; the New York futures market speculates on the spot prices; and physical gold is shipped largely through Zurich.

Before the gold market came into its own in the 1970s, London was the center for the market. Before World War I the market operated through five bullion houses that channeled gold from suppliers (mainly South Africa) and fixed a daily price. The South African Reserve Bank took over the marketing of South African gold in the 1920s, but the fixing continued to be, and still is, conducted by representatives of the five original bullion houses.

The London market closed in 1939 with the outbreak of World War II and did not reopen until 1954—several years after the Bretton Woods system had been in operation. The Bank of England, acting as agent for the South African Reserve Bank, was able to maintain the price of gold at £12.50 an ounce ($35) until March 15, 1968, when pressures to increase the price beyond $35 forced the market to close.

When the market reopened two weeks later, according to O'Callaghan, it found "a changed world of gold." Under the newly instituted two-tier market, private individuals were permitted to trade freely, but central banks could trade only with each other and only at the official price. "Because," O'Callaghan says, "the London fix was now free of intervention by the Bank of England, an afternoon fixing was introduced to attract investors from the United States." In the two weeks that the London market was closed, however, the newly formed Zurich Gold Pool, comprising the three major Swiss banks, had persuaded the South African Reserve Bank to market its gold through it.

Since 1968, Zurich has become the largest entrepôt for new gold and the world's largest storage center for new gold. According to O'Callaghan, "the Zurich Gold Pool is still thought to handle most new gold sold on the world market from South Africa and the former U.S.S.R."

Switzerland's dominance in physical gold trading depends on the "specialized banking and ancillary gold services" it provides in an "essentially unregulated and confidential environment." Despite the growing prominence of Zurich as a trading center, however, London is, according to O'Callaghan, "still considered to be the most liquid and influential in determining the spot gold price because of its twice-daily fixings." The London fixing, says O'Callaghan, "allows the rest of the world to absorb any net supply (or demand) and is regarded as the true market price by virtue of its market-clearing mechanism."

In addition to the continuing demand for physical stocks of gold, markets have been developing over the past several years for derivative physical instruments, including loans and swaps and forward sales, as well as for paper instruments.

Former U.S.S.R.: Gold Production, Sales, Consumption, and Reserves
(metric tons)

Year	Mine Production	Exports	Domestic Consumption	Change in Reserves	Year-end Reserves
1968	183.5	0.2	7.2	176.1	1,040.4
1971	208.4	60.0	36.2	112.2	1,456.6
1974	227.1	47.1	43.8	136.2	1,108.1
1977	244.2	325.0	109.8	-190.6	760.5
1980	258.2	64.7	121.8	71.7	581.6
1983	267.5	40.1	88.1	139.3	577.2
1986	271.3	75.0	102.8	93.5	680.9
1989	304.0	245.5	126.6	-66.4	784.0
1990	302.0	474.6	130.8	-299.4	434.6
1991	230.0 [1]	319.1	112.0[2]	-194.6	290.0[2]

[1]Data for January-September.
[2]Data from the Russian authorities.
Data: Data for 1986–91 are from the former U.S.S.R. Ministry of Finance as reported in *Moscow News*, November 17-24, 1991. Reserves data for 1986-90 were previously reported in IMF, *Economic Review: The Economy of the Former U.S.S.R. in 1991*, Table 34. Data for earlier years were compiled from various sources. Remaining data for domestic consumption were calculated as a residual by IMF staff.

Copies of *The Structure and Operation of the World Gold Market*, No. 105 in the IMF's Occasional Papers series, are available for US$15.00 (US$13.00 for full-time students and faculty members of colleges and universities) from Publication Services, Box S-368, International Monetary Fund, Washington, D.C. 20431, U.S.A. (Telephone: (202) 623–7430; fax: (202) 623–7201.)

From the Executive Board . . .

Lithuania: Systemic Transformation Facility. The IMF has approved credits to Lithuania totaling SDR 51.75 million (about $72 million). Of this total, the equivalent of SDR 25.875 million (about $36 million) may be drawn under a stand-by arrangement over the 17-month period ending March 1995. In addition, the IMF approved an immediate drawing of SDR 25.875 million under its systemic transformation facility. The credits will support the Government's stabilization program for 1993–94 and its efforts to transform Lithuania's economy into a market system.

While sustaining a large drop in total output, Lithuania made significant progress under its 1992–93 economic program, supported by an IMF stand-by credit. Following a decline of more than one-third in 1992, output seems to have stabilized during the summer of this year, although for the year as a whole, GDP is still expected to decrease by 15 percent. However, this estimate does not fully take into account the growing private sector. The decline in industrial and agricultural output leveled off in the first half of 1993, whereas monthly inflation, which averaged 24 percent during 1992, dropped to 14 percent in the first half of 1993 and has since declined rapidly in response to tight monetary and fiscal policies.

At the same time, Lithuania has adopted a new trade regime, abolished export licensing, lowered import tariffs, and signed free trade agreements with a number of countries. It achieved monetary independence with its withdrawal from the ruble area in October 1992 and introduction of a national currency, the litas, in June 1993. Meanwhile, nearly all residential dwellings and nonagricultural enterprises have been privatized, and socialized farms have been largely broken up into agricultural enterprises. However, progress has been less satisfactory in land privatization, and the privatization of nonagricultural land is at an early stage.

Lithuania's 1993–94 economic program is designed to continue the country's transformation to a market-based economy and to establish a sound basis for growth in a low-inflation environment. The objectives of the program for 1994 are to achieve a real growth rate of over 4 percent, reduce the annual rate of inflation to single digits by the end of the year, and limit the current account deficit of the balance of payments to some 8 percent of GDP.

To attain these objectives, the authorities will implement monetary policy consistent with the aim of reducing inflation and protecting the value of the litas on foreign exchange markets. In the fiscal area, the general Government's financial deficit will be limited to 1 percent of GDP in 1994, and additional measures will be taken to reform the structure of taxation and establish expenditure priorities in place of broadly based expenditure cuts. Trade policy measures under the program include elimination of most export taxes in 1994 and introduction of a uniform import tariff structure, with a few exceptions, by the end of 1993.

In the area of structural reforms, privatization will be extended to allow majority ownership by outside investors in medium- and large-scale enterprises, and restitution of agricultural land will continue. The regulations of the Bankruptcy Law will fully take effect by the end of 1993, and market economy accounting standards are scheduled to be in place by the end of 1994. The Government will also introduce better targeting of social benefits and reform the pension system and unemployment benefits during the program period.

Lithuania became a member of the IMF on April 29, 1992, and its quota is SDR 103.5 million (about $145 million). Lithuania's outstanding financial obligations to the IMF arising from past operations and transactions currently total the equivalent of SDR 56.9 million (about $80 million).

Press Release No. 93/47, October 25

Estonia: Systemic Transformation Facility. The IMF has approved credits totaling SDR 23.25 million (about $32 million) for Estonia. Of this amount, SDR 11.6 million (about $16 million) is available through March 1995 under a stand-by credit to support the Government's 1993/94 economic and financial reform program. An additional SDR 11.6 million is available under the systemic transformation facility (STF), and a second equal disbursement will be available, provided that Estonia continues to make progress in implementing the reform program.

Supported by its first stand-by credit from the IMF, Estonia has made progress over the past year in stabilizing and reforming its economy. Its most significant achievement has been to reduce the monthly rate of inflation from about 36 percent in the first half of 1992 to about 2 percent in the third quarter of 1993. Although the decline in output has stabilized, with signs of recovery becoming apparent over the last few months, further progress will be necessary to foster the conditions for sustainable noninflationary growth and to consolidate the reforms. Estonia has also implemented structural reforms, which have contributed to the economic transition.

The authorities' main objectives during the 1993/94 program period are to consolidate the gains already made in the transformation of the economy while maintaining macroeconomic stability. Output is expected to grow by 2 percent in the second half of 1993 and by 6 percent in 1994. Under strict monetary policies, supported by a prudent fiscal stance, the annual rate of inflation is expected to fall to single digits by mid-1994 and to decline further thereafter. The current account deficit is projected to increase, however, largely because of an expected increase in investment and imports, with gross foreign reserves being maintained at about four months of imports throughout the program period.

A tight fiscal policy remains at the center of Estonia's stabilization effort. The authorities are implementing a broadly balanced budget for the general government in 1993, and they intend, in the budget for 1994, to limit the financial deficit to no more than 1 percent of GDP. Monetary policy will focus on maintaining the integrity of the currency board arrangement and improving the ability of the banking system to support the transition. To further the development of commercial banks and assure adherence to regulatory stan-

dards, the Bank of Estonia's supervisory capabilities will be enhanced. An accounting plan for banks will be adopted in early 1994, and a plan for implementing international capital adequacy standards, as established by the Bank for International Settlements, will be developed before the end of the program period.

The program also incorporates measures to expedite the sale of enterprises and housing. Following the establishment in October 1992 of the Estonian Privatization Agency, the Privatization of Housing Act was passed in May 1993 and the Privatization Act, in June 1993. Over 50 percent of small enterprises have now been privatized, and about one hundred large enterprises are expected to be privatized or restructured by the end of 1993 or early 1994.

The authorities intend to continue to strengthen and rationalize the social safety net to ensure that assistance is channeled effectively to the neediest segments of the population. On January 1, 1994, an income maintenance program will take effect, providing support to families whose income falls below the poverty line. The Government also intends to tie the child benefit program to family incomes and to use the resulting savings to finance other social programs.

Estonia joined the IMF on May 26, 1992, and its quota is SDR 46.5 million (about $65 million). Estonia's outstanding financial obligations to the IMF currently total SDR 27.8 million (about $39 million).

Press Release No. 93/48, October 27

Stand-By, EFF, SAF, and ESAF Arrangements As of September 30, 1993

(million SDRs)

Member	Date of Arrangement	Expiration Date	Amount Agreed	Undrawn Balance
Stand-by arrangements			**1,564.96**	**1,266.70**
Costa Rica	April 19, 1993	February 18, 1994	21.04	21.04
Czech Republic	March 17, 1993	March 16, 1994	177.00	107.00
Dominican Republic	July 9, 1993	March 28, 1994	31.80	28.00
El Salvador	May 10, 1993	March 9, 1994	34.55	34.55
Guatemala	December 18, 1992	March 17, 1994	54.00	54.00
Hungary	September 15, 1993	December 14, 1994	340.00	283.30
Jordan	February 26,1992	February 25, 1994	44.40	11.10
Kyrgyz Republic	May 12, 1993	April 11, 1994	27.09	15.48
Pakistan	September 18, 1993	September 15, 1994	265.40	177.40
Panama	February 24, 1992	December 23, 1993	93.68	58.83
Poland	March 8, 1993	March 7, 1994	476.00	476.00
EFF arrangements			**4,124.98**	**1,971.01**
Argentina	March 31, 1992	March 30, 1995	2,483.15	1,056.95
Egypt	September 20, 1993	September 19, 1996	400.00	400.00
Jamaica	December 11, 1992	December 10, 1995	109.13	72.75
Peru	March 18, 1993	March 17, 1996	1,018.10	375.41
Zimbabwe	September 11, 1992	September 10, 1995	114.60	65.90
SAF arrangements			**83.23**	**38.27**
Comoros	June 21, 1991	June 20, 1994	3.15	2.25
Ethiopia	October 28, 1992	October 27, 1995	49.42	14.12
Rwanda	April 24, 1991	April 23, 1994	30.66	21.90
ESAF arrangements			**1,864.00**	**722.60**
Albania	July 14, 1993	July 13, 1996	42.36	33.89
Benin	January 25, 1993	January 24, 1996	46.95	31.29
Bolivia	July 27, 1988	March 31, 1994	163.26	13.61
Burkina Faso	March 31, 1993	March 30, 1996	48.62	39.78
Burundi	November 13, 1991	November 12, 1994	42.70	23.49
Equatorial Guinea	February 3, 1993	February 2, 1996	12.88	10.12
Guinea	November 6, 1991	November 5, 1994	57.90	40.53
Guyana	July 13, 1990	December 20, 1993	81.52	8.86
Honduras	July 24, 1992	July 23, 1995	40.68	27.12
Lao P.D.R.	June 4, 1993	June 3, 1996	35.19	29.33
Lesotho	May 22, 1991	August 1, 1994	18.12	3.78
Malawi	July 15, 1988	March 31, 1994	66.96	5.58
Mali	August 28, 1992	August 27, 1995	60.96	40.64
Mauritania	December 9, 1992	December 8, 1994	33.90	16.95
Mongolia	June 25, 1993	June 24, 1996	40.81	31.54
Mozambique	June 1, 1990	December 1, 1993	100.65	–
Nepal	October 5, 1992	October 4, 1995	33.57	22.38
Sri Lanka	September 13, 1991	September 12, 1994	336.00	112.00
Tanzania	July 29, 1991	July 28, 1994	181.90	96.30
Uganda	April 17, 1989	November 24, 1993	219.12	19.92
Zimbabwe	September 11, 1992	September 10, 1995	200.60	115.50
TOTAL			**7,637.17**	**3,998.58**

Note: EFF = extended Fund facility.
SAF = structural adjustment facility.
ESAF = enhanced structural adjustment facility.
Figures may not add to totals because of rounding.

Data: IMF Treasurer's Department

IMF Lending In September

The IMF committed SDR 1.0 billion (about $1.4 billion) for two new stand-by arrangements and one extended arrangement in September. These comprised stand-by arrangements for Hungary (SDR 340.0 million, about $482.1 million) and Pakistan (SDR 265.4 million, about $376.3 million), and a loan for Egypt under the extended Fund facility (SDR 400 million, about $567.2 million).

Disbursements for the year through September were substantially higher than a year earlier. Disbursements of IMF general resources were SDR 4.1 billion (about $5.8 billion), compared with SDR 3.0 billion (about $4.3 billion) during January-September 1992. Lending in 1993 through September under the systemic transformation facility (STF)—created on April 23, 1993—amounted to SDR 1.3 billion (about $1.8 billion).

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NATIONAL ECONOMIES

Ukraine's Economy Drifts as Political Concerns Interfere with Adjustment

"Despite occasional rhetoric in favor of sound money, the [Ukrainian Government's] approach in practice has been to subordinate financial policy to the achievement of real objectives, such as attempting to sustain production of key products, keeping insolvent state enterprises afloat, and appeasing powerful interest groups." Hugh Bredenkamp, the IMF's desk economist for Ukraine, made this statement at the beginning of his presentation at an IMF Visitors' Center seminar, held on September 14, whose theme was "Ukraine's Integration into the World Economy."

Developments During 1992–93

Bredenkamp noted that Ukraine's financial policies over the past year and a half have resulted in a "hemorrhage of subsidies and cheap credit" and commented that the ability of the Ministry of Finance and the National Bank of Ukraine to resist political pressures was severely weakened by the failure to agree, at a political level, on a credible, consistent, and quantified financial strategy. Although Ukraine set a target for its 1992 fiscal deficit of 2 percent of GDP, the deficit, financed entirely with central bank credit, ballooned to almost one-third of GDP by the year's end. The stock of bank credit to enterprises also increased 27-fold during 1992. Bredenkamp cautioned that Ukraine now stood "on the brink of hyperinflation," adding that its underlying inflation rate was more than 40 percent a month, while the U.S. dollar value of its currency, the karbovanets, has fallen by more than 95 percent since the beginning of 1993.

The Ukrainian economy, Bredenkamp acknowledged, has experienced severe systemic shocks—for example, a four- or fivefold increase in its energy import bill, measured as a percentage of GDP—since becoming independent two years ago. He stressed, however, that "allowing the budget and money supply to spin out of control . . . was not an inevitable response, as the experience of the Baltic countries has shown." Just as Ukraine's plans for financial reform have languished, so have its plans for structural reform. Commenting on price reform, Bredenkamp observed that, currently, although the prices of more goods are determined by the market than were two years ago, the culture of controlled prices remains, and controls still apply to a significant number of key commodities.

The IMF economist also observed that enterprise behavior in Ukraine has changed relatively little over the past two years. The ownership structure, management incentives, and financial environment remained largely unreformed. Bredenkamp pointed out that by the end of 1993, Ukraine's cumulative fall in output since 1990 was likely to exceed 40 percent. "Gradualists," he asserted, " . . . will be disappointed to learn that the combination of easy money and a slow start on structural reform has not prevented a sharp, and currently accelerating, decline in production." Bredenkamp contrasted Ukraine's experience with those of what he termed the "shock therapists" in the governments of the Baltic states of Estonia, Latvia, and Lithuania. Although these countries have experienced roughly the same decline in output as Ukraine over the past three years, he said, the Baltics have now more or less stabilized their economies and have considerably brighter near-term prospects.

Havrylyshyn: Ukraine must pursue economic stabilization and reform.

Lessons from Ukraine's Experience

Bredenkamp identified four main lessons from Ukraine's experience:

- The government of a reforming economy needs to establish a political base from which to launch strong policies.
- A comprehensive price liberalization should take place at the early stages of a macroeconomic stabilization and structural adjustment program. On this point, Bredenkamp commented that some participants in the debate on se-

quencing of economic reforms had argued that macroeconomic stabilization should precede the freeing of prices on a large scale. He noted, though, that this was simply not feasible in Ukraine because the authorities had neither the technical capacity nor the effective power to implement such a system of price controls without fostering a rising demand for subsidies and cheap credits.

• The business environment in a transforming economy needs to be reformed at an early stage, so that the financial incentives and constraints facing state enterprises and their managers can be changed. Bredenkamp observed that the privatization, as well as start-ups, of small businesses should be encouraged because "they can create obvious signs of change, both real and superficial, which give people hope of a brighter future even while the pain of reforms is beginning to bite." He added that a thriving small-business sector could do a lot to mitigate the impact on output and employment opportunities of a depressed or shrinking state sector.

• Preparing the ground for the country's introduction of a new currency is important. Bredenkamp emphasized that the principal task was to put into place the institutional framework—notably, a well-functioning central bank and sensible exchange arrangements—together with solid financial policies to support the new currency.

Privatization Efforts

Roberta Feldman, an Investment Officer with the International Finance Corporation who has recently returned from an extended stay in Ukraine, expressed the view that Ukraine was having a particularly difficult time in achieving economic transition. The primary reason is the current composition of its government, whose two principal elements are old-guard communists and former dissidents. (The latter "are very enthusiastic and concerned about Ukraine's political independence but are not focused on Ukraine's economy.") Feldman commented that Ukrainian officials she had spoken with felt that the country could afford to wait for economic stabilization and reforms to be implemented on a large scale.

Feldman noted that, according to Ukraine's Ministry of Statistics, only 1,028 enterprises of various kinds have been privatized since independence, compared with about sixty thousand firms in Russia. Even granting the considerable difference in the size of the two countries, the numbers make it clear that Ukraine's privatization efforts are lagging. Data provided by the Ministry of Statistics also indicate that Ukraine currently has 98 percent state ownership of businesses, with the remaining 2 percent in private hands.

Feldman stated that most privatizations in Ukraine involved transfers of a firm from the state to a labor collective—that is, to an organization made up of the firm's employees. Owners of privatized firms are prohibited by law from transferring ownership to others, thus calling into question whether true private ownership of the means of production has actually been achieved. She noted that some Ukrainian officials doubt that many business owners in Ukraine are capable of actually operating under a market system. At the same time, however, there is considerable grass-roots support in the regions of Ukraine for privatization.

According to Feldman, privatization has an image problem in Ukraine, as elsewhere in the states of the former Soviet Union, because the products many small, private retail businesses are currently selling—Western liquor, cigarettes, chocolate, and the like—"have nothing to do with . . . normal life . . . are not nutritious, are not wholesome." This contributes to the Ukrainian public's fears that privatization will not bring them the bread, meat, and other staple items they need to live. One reason for this public perception, Feldman noted, is that Ukraine's existing wholesale networks—which originated under central planning—still have a lock on the distribution of most products within the country, the few exceptions being the Western luxury products mentioned earlier.

Feldman described how criminal groups in Ukraine use their hold on the distribution of products to extort money from private businesses. She noted that, for example, in Kiev, new businesses, even before they opened, were routinely shaken down for protection money.

Businesses that have failed to cooperate with these criminal groups have on occasion been burned or blown up, which has had a chilling effect on entrepreneurial activity. Feldman stated that Ukraine's law-enforcement agencies have been generally ineffectual in dealing with these illegal activities. Because the people controlling the networks were the richest and most powerful people at the local level under the Soviet system, only determined central government action, including considerably strengthened law enforcement, can dislodge them.

In Feldman's view, there is a lack of direction from Ukraine's central government concerning privatization efforts. She noted that a draft law that would resolve a number of current problems hindering privatization efforts has recently been issued by the central government but must be ratified by the Supreme Soviet, or parliament, to become effective.

A Ukrainian Perspective

Oleh Havrylyshyn, currently the Alternate Executive Director for the

constituency of IMF members that includes Ukraine and formerly Ukraine's Deputy Finance Minister, noted that Ukraine's negative colonial inheritance led its leadership to focus on building key institutions of a nation-state: political, military, and cultural. But now it was essential to focus on building "the fourth wall of the bastion of independence . . . namely, . . . [that comprising] economic stabilization and economic reform." Commenting on Bredenkamp's earlier remarks on financial policies, he acknowledged their failure but asserted that the more important issue is why a consensus has not been reached in Ukraine to permit the Government to take the actions necessary to permit these policies to succeed.

On the problems Ukraine is having with criminal groups monopolizing its distribution networks, Havrylyshyn said these are by no means unique to Ukraine and, in fact, are being experienced in virtually all of the former Soviet states and satellite countries. He emphasized, however, that the main cause of criminalization is not inadequate enforcement or, as some suggest, too-rapid reform. To the contrary, it is insufficient reform, which has prevented real competition and, hence, real, beneficial entrepreneurship.

The Alternate Executive Director described a number of steps that he believes should be taken to integrate Ukraine more effectively into the world economy:

- Stabilization should begin with an

Currency Units per SDR

Currency	OCTOBER 20	21	22	25	26	27	28	29	NOVEMBER 1	2
Deutsche mark	2.31062	2.30189	2.32488	2.33125	2.34123	2.33367	2.33612	2.33358	2.34375	2.35908
French franc	8.15043	8.16182	8.12768	8.14258	8.16233	8.16254	8.21918	8.17441	...	8.2255
Japanese yen	149.852	151.064	150.995	150.794	151.028	150.786	150.154	150.715	150.903	150.261
Pound sterling	0.942196	0.93943	0.941221	0.937623	0.942948	0.939962	0.939394	0.939827	0.935784	0.93829
U.S. dollar	1.40114	1.40069	1.39423	1.39237	1.39028	1.3934	1.39096	1.39293	1.39869	1.38745
Argentine peso	...	...	...	...	...	...	...	...	...	...
Australian dollar	2.10825	2.09277	2.08405	2.0847	2.07504	2.09282	2.0901	2.09117	2.0868	2.08159
Austrian schilling	16.2364	16.2046	16.3655	16.3993	...	16.4059	16.4272	16.4129	...	16.5703
Bahrain dinar	0.526829	0.526659	0.52423	0.523531	0.522745	0.523018	0.523001	0.523742	0.522223	0.521681
Bangladesh taka	55.8354	55.8175	55.5601	55.4859	55.4027	55.527	55.4296	55.5063	55.3473	55.2699
Belgian franc	50.3114	50.2603	50.4572	50.7568	50.7452	50.5685	50.6692	50.6643	...	50.9125
Brazilian cruzeiro	215.635	218.914	221.25	224.38	227.505	231.538	234.709	238.734	241.68	...
Canadian dollar	1.85147	1.84486	1.81919	1.82233	1.836	1.8372	1.83941	1.84076	1.82667	1.81104
Colombian peso	1256.03	1255.33	1250.14	1249.15	1247.72	1251.22	1249.61	1252.08	...	1247.68
Danish krone	9.36541	9.3412	9.3755	9.35533	9.41915	9.3957	9.42445	9.4189	9.43334	9.44298
Finnish markka	7.92527	8.01111	8.05154	8.02256	8.03693	8.06416	8.07466	8.01589	8.0532	8.05151
Greek drachma	336.204	335.409	336.916	336.592	335.892	334.723	334.136	334.261	335.209	336.686
Indian rupee	43.9638	43.9396	43.737	43.6786	43.6131	43.711	43.6344	43.6962	43.5866	43.5243
Indonesian rupiah	2953.6	2961.25	2939.04	2933.72	2927.93	2933.11	2927.97	2932.12	2925.	2921.97
Iranian rial	2219.41	2218.69	2208.46	2205.51	2202.2	2207.15	2203.28	2206.4	2255.58	2260.16
Iraqi dinar	0.435555	0.435415	0.433407	0.432828	0.432179	0.433149	0.43239	0.433002	0.431747	0.431299
Irish pound	0.986163	0.986909	0.987085	...	0.990792	0.990616	0.99532	0.990141	0.994052	0.993733
Italian lira	2243.84	2250.74	2240.82	2242.89	2253.2	2264.55	2264.79	2264.5	...	2265.44
Korean won	1134.16	1133.86	1128.21	1126.57	1124.74	1127.82	1125.84	1126.74	1122.5	1120.5
Kuwaiti dinar	0.416549	0.416414	...	0.416458	0.416	0.416068	0.415039	...	...	...
Libyan dinar	0.446429	0.446429	0.446429	0.446429	0.446429	0.446429	0.446429	0.446429	0.446429	0.446429
Malaysian ringgit	3.5645	3.56378	3.55041	3.54706	3.55036	3.55874	3.55557	3.56214	3.56417	3.55361
Maltese lira	0.539149	0.538665	...	0.541041	0.542294	0.542432	0.542369	...	0.543342	0.543821
Nepalese rupee	68.9921	68.97	68.6519	68.5803	68.4574	68.611	68.4909	68.5679	68.3689	68.318
Netherlands guilder	2.59519	2.60402	2.61153	2.61585	2.62958	2.62656	2.6367	2.62177	2.63278	2.6449
New Zealand dollar	2.52503	...	2.50871	...	2.49736	2.50927	2.50714	2.51341	2.5016	2.50262
Norwegian krone	10.1036	10.0808	10.1444	10.1539	10.1789	10.1767	10.2013	10.1976	10.2243	10.2428
Omani rial	0.538738	0.538565	0.536081	0.535366	0.534563	0.535762	0.534824	0.535582	0.534026	0.533475
Pakistan rupee	42.2096	42.1961	42.0015	41.9454	41.8825	41.9765	41.9029	41.9623	41.8406	41.7972
Portuguese escudo	238.833	238.647	240.018	240.429	242.038	241.77	241.285	240.506	...	242.548
Qatar riyal	5.10015	5.09851	5.075	5.06823	5.06062	5.07196	5.06309	5.07027	5.06558	5.05032
Saudi Arabian riyal	5.24727	5.24558	5.22139	5.21443	5.2086	5.21829	5.20915	5.21652	5.20139	5.196
Singapore dollar	2.21058	2.20833	2.19145	2.19075	2.18163	2.18471	2.19452	2.19874	2.20972	2.20993
South African rand	4.69732	4.70002	4.68949	4.67908	4.69289	4.69158	4.68823	4.67119	4.67848	4.66056
Spanish peseta	186.399	186.942	186.982	186.486	187.02	186.604	187.835	187.029	...	188.513
Sri Lanka rupee	68.8686	68.8754	68.631	68.5916	68.5234	68.6772	68.5562	68.6248	68.4549	68.4048
Swedish krona	11.0781	11.1425	11.2201	11.251	11.2745	11.2838	11.3342	11.3517	11.3364	11.3688
Swiss franc	2.03474	2.0359	2.04803	2.05896	2.06248	2.05868	2.06279	2.06084	2.07153	2.0696
Thai baht	35.4068	35.4094	35.3298	...	35.2575	...	35.2747	35.2968	35.2223	35.1857
Trinidad and Tobago dollar	7.9872	7.99657	7.95412	7.94289	7.92496	7.94249	7.92815	7.95126	7.92741	7.91536
U.A.E. dirham	5.14358	5.14193	5.11822	5.11139	5.10372	5.11517	5.10621	5.11345	5.09862	5.09333
Venezuelan bolivar	139.133	139.229	138.796	138.819	138.819	139.27	139.168	139.572	...	139.231

Notes: 1. The value of U.S. dollar in terms of the SDR is the reciprocal of the sum of the dollar values, based on market exchange rates, of specified quantities of the first five currencies shown. The exchange rates used for this purpose are noon rates in the London foreign exchange market. When the London market is closed, noon rates in the New York market are used. Frankfurt fixing rates are used when the New York market is closed. 2. The value in terms of the SDR of each of the other currencies shown above is derived from that currency's representative exchange rate against the U.S. dollar as reported by the issuing central bank and the SDR value of the U.S. dollar, except for the Iranian rial and the Libyan dinar, the values of which are officially expressed directly in terms of the domestic currency units per SDR.

Data: IMF Treasurer's Department

effort to bring current, runaway inflation under control by terminating the Government's loose credit policies.

• Industrial countries need to provide much wider support to Ukraine, perhaps following the IMF's lead in making some funds available in the future under its systemic transformation facility, to help it meet its huge balance of payments needs. Havrylyshyn stated that this support would buttress stabilization and structural reform efforts by relieving the pressure created by Ukraine's current crippling shortage of oil, thereby giving the authorities considerably more room to maneuver. He emphasized that industrial countries need to "make clear in advance that there will be such a quid pro quo when there is a viable program of economic reform and stabilization proposed by the Ukrainian authorities."

• A series of structural reforms—including privatization, price liberalization, and other measures to encourage market-based activity—must be implemented.

• After the preceding steps have been taken, Ukraine should be able to attract a significant amount of foreign direct investment, which it could use to improve the international competitiveness of domestic production and make significant progress toward integrating itself into the world economy.

• Tariffs and other import barriers should gradually be reduced. On this point, Havrylyshyn cautioned that Ukrainian firms are currently highly uncompetitive internationally, which justifies the maintenance of protective barriers for now. But, he added, firms should be put on notice that these barriers will be phased out over time.

Havrylyshyn supported eventual formation of an Eastern European Community but opposed a return to regulated trade among the states of the former Soviet Union. He noted there is some support in Ukraine for the view that Ukrainian firms currently cannot compete in international markets with their substandard products, and should first try competing with the other states of the former Soviet Union before entering global competition. Havrylyshyn opposes such a course on the grounds that it is a gradualist fallacy that will merely postpone Ukraine's day of reckoning with the realities of the world economy.

The IMF published its second economic review of Ukraine in September 1993. It contains background on Ukraine and information on current economic and financial developments there. The publication, No. 10 in the IMF's Economic Reviews series for 1993, was prepared by a staff team led by Peter Hole of the European II Department. Copies are available for US$15.00 each from Publication Services, Box S-379, International Monetary Fund, Washington, DC 20431, U.S.A. (Telephone: (202) 623–7430; fax: (202) 623–7201.)

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